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"Gold rushes" tend to encourage impetuous investments. As few will pay off, but when the frenzy is behind us, we will look back incredulously at the wreckage of failed ventures and wonder: "Who funded those companies? What was going on in their minds? Was that just mania at work?"

Bill Gates, *The Road Ahead*
New York,1995

Inflation - Deflation, Part II

The new U.S. Treasury Secretary, Lawrence Summers, must wonder occasionally whether his predecessor, Robert Rubin, left his position with perfect timing, both in regards to the stock market and the dollar. Until recently, the dollar's slump against the yen has been belittled as solitary yen strength, not dollar weakness. Meanwhile, though, a quiet sell-off of dollars also has been going on against the euro and the Swiss franc which had been aggressively shorted by the leveraged speculating community in "carry trade." Very similar to the turnaround in the stock market, the U.S. currency is weakening despite still-prevailing dollar bullishness. Poor fundamentals are, at long last, overwhelming sentiment.

Trying to assess the future course of the dollar, we see two phases. In the first one, in which we are, the currency markets are discounting a moderate recovery in Japan and Europe, involving a gradual shift out of dollar investments and into assets in these currencies. In our view, this is the rather harmless early part of the impending dollar decline.

Whether or not a severe dollar crisis will develop will be determined not in Europe nor in Japan, but exclusively by coming events in the U.S. economy and its financial markets. What is going to happen to them is the all-important question looming over the currency markets and the world economy.

For the time being, any dollar worries relate chiefly to the risk that a too-strong U.S. economy will force the Fed to further rate hikes. The perception is that the higher rates, by hurting both the U.S. bond and stock market, will accelerate the investors' move into the European and Japanese markets - leading to dollar weakness, if not dollar crisis. For the time being, there is strong hope in the markets that the Fed will manage a soft landing of the economy, implying equally a soft landing of the financial markets and the currency.

THE CATCH-22 DILEMMA

We have to admit that our persuasion of a looming dollar crisis starts from just the opposite assumption that the currency's great decline will start in earnest when the U.S. economy begins to show signs of significant weakening. First of all, this is the regular historical pattern for the dollar's behavior. It is odd that it falls against the backdrop of a strong U.S. economy and rising interest rates. Second, in the present euphoric environment it would come as a shock to the markets. And third, it would quickly reveal a hazardous policy dilemma for the Fed.

Actually, Mr. Greenspan's present policy dilemma is nothing compared to the one he will have to cope with during a weakening economy and a falling dollar. Prevailing high-riding confidence in his genius to engineer a soft landing of the economy is grounded in the faith that he will promptly slash interest rates once the economy begins to show undesired sluggishness. Well, this widespread hope overlooks the eminent dependence of the U.S. economy on a strong dollar for the funding of its huge trade deficit. In reality, the Fed will face a Catch-22 dilemma of the worst kind. Given the immense size of the gap in the balance of payments, any sharp U.S.

rate reductions would unquestionably risk rapid, massive capital outflows, triggering a dollar collapse. Essentially, the brunt of a dramatic reversal in capital flows would fall heavily on the U.S. financial markets, causing the financial crunch that the Fed has tried to avoid with its interest rate policy.

It is true that in times of conflicting external and domestic policy requirements, the Fed has principally and categorically adhered to the latter, leaving it kindly to foreign central banks to prevent a dollar collapse. But this time, Mr. Greenspan has to cope with imbalances of unprecedented size. They are the monstrous trade gap, the accumulated foreign indebtedness and the highly vulnerable, over-leveraged financial markets.

THEY RANG A BELL

On Sept. 28, the price of gold exploded in response to a press release from 15 European central banks with the bland title, "Statement on Gold." The brief statement contained five declarations of intent, of which the first one had a defiant ring: Gold will remain an important element of global monetary reserves. But the crucial parts of the agreement among the signatories are two stipulations: first, to stop selling gold, with the exception of already decided sales (by the United Kingdom and Switzerland), and second, to cap the leasing of gold and the use of gold futures and options at current levels.

As the signatures suggest, the move was orchestrated by the euro-zone central banks, supposedly on German and French initiative and request. But why have they done this? British and American commentators, in particular, deride investing foreign exchange reserves in a poorly performing asset, like gold, as a waste of public money. Gold bears tend to discard the move as an irrelevant gesture that is unable to cause more than just a temporary short-covering rally in gold. Others, gold bugs above all, believe we'll see a "new gold policy" by the European central banks, aiming over time to dethrone the dollar as the world's key currency.

The European bankers probably simply listened to reason by putting an end to one of the most outrageous follies ever perpetrated by central banks in history. Gold-holding central banks had been directly complicit in the massive leveraged speculation against gold. That folly, though, was not their gold sales, which attracted great publicity, but—hardly known to the public—their rapidly escalating gold leasing or lending, the so-called "gold carry trade," involving an estimated 5,000-6,000 tons of gold owned by central banks.

What was it about? Keen to earn at least a small return on their gold reserves, many central banks in the past years have been lending or leasing a part of their gold holdings at rock-bottom interest rates of 1-2% to big bullion dealers around the world, which happen to be the world's largest commercial and investment banks. These banks lent on this gold either to gold mining houses or to investment funds, prominently hedge funds. The borrowed gold was sold in the spot market in order to use the proceeds for investment in higher-yielding securities. We have seen what these heavy sales of borrowed central bank gold did to its price.

Gold carry trade, just like yen carry trade, had become a big source of cheap and plentiful credit for financial speculation, considering that gold lease rates, offered by the central banks, were generally 300-400 basis points below the dollar LIBOR rates in the market. In this way, the central banks outrageously provided huge amounts of heavily subsidized credit for financial speculation against an important asset in their balance sheets. That the persistently sliding gold price lured further extensive short-selling by speculators bent on profiting from the falling price, goes without saying. There was no risk of a gold rally. Its price could only go one way—down. Everybody knew it, even the central bankers.

The other big player in this game of shorting gold, as already mentioned, were the gold mines themselves. Having to cope with a persistent fall in the gold price, many decided to take "insurance" in the derivatives markets. Yet other firms were willing to suffer the vicissitudes of the gold market because they realized that the short selling was precipitating the fall in the price of their product.

To understand the abrupt surge in the gold price, one has to know this background. The gold moratorium of the European central banks happened to prick a huge short-selling bubble with the apparent paradoxical effect

that the shares of gold mines dramatically diverged. Those that were heavily hedged went south, while those that had done little or no hedging went north.

The shares of one of the richest gold mines in the world, Ashanti Goldfield in Ghana, which is heavily caught in the derivative blow up, plunged instantly by 70%. Gold shareholders normally buy gold shares because they believe in the value of the companies that produce gold. In this Theater of the Absurd, many gold shares were bought because the companies were aggressively shorting gold.

Like most other big, old gold mining companies, Ashanti had extensively used the futures and options markets to, in effect, sell its future gold production at old prices. Since the gold price has been falling steadily for years, it made handsome profits with this practice. But the sudden surge in the gold price has taken it to a higher level than the prices contained in Ashanti's derivatives deals. According to Ashanti, its outstanding derivatives were worth $290 million in June but went to $570 million in the red.

Given the persistent fall in the gold price, most of the gold mining companies had decided long ago to protect themselves either fully or partly against this income loss through hedge positions of two categories—forward sales or option positions. Forward positions were mostly utilized until the mid-1990s, but hedging positions have since then become far more complex, with options becoming prevalent.

THEATER OF THE ABSURD

A forward hedging position implied that a gold mine borrowed gold from one of those bullion trading banks. It then sold the gold against cash and invested the proceeds in high-yielding securities. When the contract expired at some later date, it returned the gold, with interest, either from the mine's future output or from purchases in the market at lower prices. In reality, though, existing short-term contracts were persistently prolonged. The short position in gold continued to expand.

Lately, though, the hedging was overwhelmingly done through the purchase of put options, which give the right to sell gold at the contracted striking price, but to walk away if the market price is to the buyer's disadvantage. Since such options are very expensive, however, many companies choose to finance them by writing and selling call options, collecting high premiums for them, to pay for the expensive put options—a strategy abundantly used by Ashanti. Such call options gave the purchasers the right to buy gold within a certain span of time at a fixed price. Given the incessant fall of the gold price, the gold mines profited both from their put and their call options. Conversely, the abrupt, sharp rise of the gold price has heavily hit them on both counts. As a result, they have to sell at the lower put prices and to buy at the high call prices.

It has been an open secret that many gold producers had built grossly over-hedged positions by using the futures and options markets not simply for insurance purposes, but for outright speculation. Ashanti is just the first ones that has come public with its problem. The numerous others, equally on the ropes, prefer to keep silent, hoping for a sharp reversal in the gold price to allow them to unwind the positions on their books without too much pain. That is, put options have been bought at a scale far in excess of their potential physical production, implying that they will have to cover the shortfall through gold purchases at the high prices in the market.

HIGH STAKES

In reality, however, there is a lot more at stake than the bankruptcy of a number of gold producers. It will emerge over time that the intermediaries (the big gold dealing banks which borrowed the gold from the central banks and lent it on to third parties) will prove the far greater problem, possibly a very serious problem. This arises from the fact that they are the ones that bear the ultimate responsibility vis-à-vis the central banks to return the borrowed gold (estimated at 5,000-6,000 tons) at the low contractual prices of the past. The short selling of gold has acquired a dimension that puts large banks at risk. What will happen to the leading banks of

the world if the gold price rises to $400 and higher and many of their debtors (gold mines and hedge funds) go bankrupt?

The total short position in gold is unknown, at least to outsiders. Yet it's easy to see that it is a multiple of the annual new gold production of around 2,500 tons. This essentially implies that a very large part of the gold that the bullion banks owe to the central banks has to be bought in the market at rising prices. On top of this, these same bullion banks have created huge short positions in "paper gold" through the derivatives markets that vastly exceed the amounts sold forward by the gold producers.

Ironically, central banks must be afraid of too steep a rise in the gold price for fear of the stability of the big gold dealing banks. It would essentially force the same central banks that precipitated the recent rise to intervene with gold sales to stop it. They certainly cannot insist on fulfillment of the existing contracts to return the gold. For good reasons, the 15 central banks have been careful only to call a stop to new gold sales and leases, but not to demand cuts in existing positions. Nevertheless, there is something out there that is too big to be under their control: the derivatives behemoth. If the gold price should stage a prolonged rise toward $400 per ounce, the bear speculators in general will be savagely squeezed both on their put and their call exposure.

Mr. Greenspan's view that use of derivatives reduces risk is once more dramatically refuted. The truth is that risks in the system are not reduced, but merely transferred from one party to another. But the ability to shift risks to somebody else enhances the readiness of speculators to take ever-greater risks. It was the unlimited possibilities offered by the derivatives markets that fostered and fueled the craze in the gold market. The net result of the proliferating "risk redistribution" at the micro level through derivatives is the creation of unprecedented systemic risk at the macro level. Last but not least, this "gold rush" is compelling proof that the prices of the underlying assets are grossly distorted.

RISING VOLATILITY AND VULNERABILITY

After stabilizing for much of the summer, U.S. credit markets faltered markedly in late September and throughout October. The blow-up of leveraged gold short and derivative positions, as well as the acute dollar weakness pressuring euro and Swiss franc carry trades, certainly exacerbated fixed-income liquidations within the leveraged speculating community. Heightened systemic stress was also apparent as the TED spread shot up from 97 to 110. The Fed is now widely perceived as having fallen behind the curve. Credit markets are on heightened alert to central bank tightening.

Although the majority of stocks are clearly in a bear market, major U.S. indices have held up surprisingly well, albeit with extraordinary volatility. As has been the case all year, "blue chips" continue to dramatically underperform the more speculative high tech issues. With the S&P 500 holding a 1999 gain of 6%, the NASDAQ sports a rise of 35%. We suspect increasing disorder among the leveraged speculators. With accumulating losses from bets gone awry in various markets, many proceed to reduce positions and shed risk.

Another key factor, likely fostering volatility and divergences, is the proliferation of derivatives for speculating hedging. For September, open interest on the Chicago Board Options Exchange exploded, rising more than 40% during a single month. Open interest in equity option positions now exceeds 30 million contracts and this, of course, excludes option exchanges and the important over-the-counter derivatives market. We suspect that the leveraged speculating community, betting on a sharp pullback, heavily shorted call options, particularly in the large and relatively liquid technological stocks that dominate NASDAQ. With the subsequent outperformance of the tech sector, this mountain of derivatives essentially added to wild volatility and disjointed trading.

This was certainly the case for the large NADAQ stocks, as the hypervolatile NASDAQ 100 index abruptly shot to a record high on Oct. 12, only to drop 10% the next five sessions. A subsequent violent rally then recouped much of the lost ground again. As already mentioned, the NASDAQ 100 maintains a 35% year-to-date

rise and 52-week gain of 85%. Likewise, the Morgan Stanley Technology index has 1999 and 52-week gains of almost 40% and 105%.

For some time, euphoric investors and aggressive speculators have ignored a lengthening list of technology disappointments. Now, with the likes of industry leaders IBM, Intel, Hewelett-Packard and Dell disappointing, the only question remaining is whether the air will come out of this technology bubble quickly or over a protracted bear market. In this respect, we have a keen analytical interest in derivative dynamics. While derivatives have certainly played a key role in propelling NASDAQ higher this year, we strongly suspect that existing considerable derivative-related leverage will be a major force in exacerbating the market's decline. With the plethora of momentum-chasing players and major institutional investors now heavily overweight the tech sector, we do see all the ingredients for collapse when the crowd wants to lock in profits by selling. Add to this the unprecedented hundreds of billions of employee stock options overhanging the market. After all, we view the U.S. technology, Internet and communications bubble as one of history's greatest manias, and manias simply do not end with a whimper. Moreover, with the key financial sector already in a savage bear market, it is our view that as the technology bubble goes, so goes the U.S. stock market. Concomitantly, the dollar came under selling pressure, sinking about 5% against the euro and Swiss franc.

A WORLD OF LOW INFLATION

Ending in the 1990s, the industrial economies have achieved what many regard as virtual price stability, meaning inflation rates at 2% and less. Inflation across the euro-zone is running at just 1.2%. In Britain, the comparable figure is 1.3%. In the United States, excluding food and energy prices, inflation stands at 1.9%, while Japan is suffering deflation with a declining price level.

The happy, general view in the markets is that the policymakers, particularly the central banks, have done an excellent job in holding down prices. It is certainly a comforting thought that the central bankers around the world have finally seen the light to accomplish this great achievement. Unfortunately, there is very little truth in this assumption. In fact, none at all. Considering that the industrial countries have experienced rampant money and credit growth during the past years, it should be manifest that the arrival of these low inflation rates is definitely not attributable to the outbreak of new wisdom among the central bankers of the world. It has definitely happened despite their extremely loose policies.

As a matter of fact, this realization that the break in the former inflation trend essentially originates in other influences than monetary policy is a main reason why we refuse to take recurrent inflation fears and jitters in the markets seriously. This inherently suggests that the prevailing global trend towards low inflation and even virtual price stability in many countries is structural and secular. But what are the underlying causes for this change in the inflation trend?

Trying to refresh our knowledge of history, we decided to consult the two volumes of Schumpeter's *Business Cycles*. Most probably, he would classify the change as a typical symptom of a Kondratieff downgrade. In his book, published in 1939, he identifies three long-term Kondratieff waves. The first one he dated from the 1780s to 1842. The second one, the Kondratieff of steam and steel, stretched over the following 55 years to 1897. The third one, the Kondratieff of electricity, chemistry and motors, he dates from 1898. His book ends with the description and analysis of "The Disappointing Juglar" in the second half of the 1930s, referring to President Roosevelt's failure to revive the U.S. economy with rock-bottom interest rates and massive deficit spending. Isn't that Japan in the 1990s?

THE ESSENTIAL THING

Joseph Schumpeter is unique in economic theory and history by holding the view that the "essential thing" at the heart of great booms and manias are *innovations*, discarding money and credit as secondary factors. For

sure, the great speculative manias in history were connected with innovations that generated great popular excitement. Nevertheless, it essentially needs the fuel by which the fire is fed: a money and credit deluge, and it was never missing.

At any rate, Schumpeter's detailed description of the prosperity phases in the three Kondratieff waves during the whole course of the Industrial Revolution prompted us to draw some critical comparisons with the economic effects of the present Information Revolution. It can be put into one key question: What are the effects of this new technology in terms of income and real capital creation?

Comparing the Industrial Revolution in this respect with the present Information Revolution, we realized one decisive difference. In fact, the decisive difference. In contrast to what is generally thought, changes in productivity growth which, intrinsically, develops very gradually, are not the decisive factor. It lies in the process of implementing the new technology. Putting it into plain language: The essential thing is the capital formation process, involving the production of fixed capital that the specific technology implicates.

"Prosperity phases" in the course of the Industrial Revolution were always periods of high rates of capital investment incident to high rates of employment and income creation. The essential and crucial point was that the implementation of the industrial technology required in general a high capital input. Intrinsically, this gave rise to the development of large-scale capital goods industries which, with their production, importantly swelled employment and income. Railroadization, electrification and motorization radically changed the economic world and the way of life.

To reiterate and stress the one point of crucial importance: *The great prosperity brought about by the Industrial Revolution arose entirely out of the inherent, massive capital creation and its attendant massive employment and income effects.* Putting it into familiar Keynesian language: The capital and investment spending implementing the new Industrial Technology had tremendous "multiplier effects" on the level of employment and income across the whole specter of the economies

Bearing in mind how the Industrial Revolution over the last 150 years has in various waves created immense prosperity through the large-scale, capital-intensive investment that it required, we keep wondering and wondering about the way this pattern (creation of capital, employment and incomes) is working out in the case of the new Information Technology.

INFORMATION HIGH TECH, THE GREAT ECONOMIC FLOP

To give a short answer to this central question right away: Like everybody else, we look at the high tech of today as a virtual technological miracle. And for sure, this technology has made information available as never before. But we ask, so what? First and foremost, we find it an incredibly naive belief that a rising quantity of information intrinsically leads to a rising quality of decisions, in particular in economics, and that the better decisions create unprecedented prosperity. Reading and hearing such nonsense, we realize that the level of thinking, far from rising with the level of information, has collapsed.

Being familiar with what the old economists thought and wrote, we have already been, for some time, holding the opinion that *macro-economic* thinking in the 1990s has gone into complete eclipse, and one of the reasons for that is the computer. Definitely, the computer has been the central conditioning factor in promoting and facilitating the unprecedented speculative excesses in the financial markets, and the future will show that these excesses have done immense damage to the structure of the U.S. economy. True, these speculative excesses have generated tremendous wealth—on paper. But the source of this wealth is not savings and real investment, nor the Internet —it is unprecedented financial leverage.

To make one thing absolutely clear: Prosperity does not come just from better thinking. The essential thing

is how the new technology translates into those effects on which rising overall prosperity depends. We have shown and explained how the great industrial prosperity came about: through massive capital investment. And we hasten to add that we fail to see any other possible way to generate greater prosperity.

These observations and considerations concerning the Industrial Revolution have led us to the conclusion that the high tech miracle we are currently experiencing definitely lacks those essential properties that could ever turn it into an economic miracle, like the Industrial Revolution did. From a macro-economic point of view, the new high tech is bound to prove a great economic flop. Why?

In the eulogies on high tech, one argument is paramount: The Internet puts the customer in charge as never before because, through the Internet, virtual upstarts can reach customers faster for a small fraction of the cost of stores and salespeople. OK, that's great. But the trouble is that general prosperity (in contrast to individual prosperity) only comes from the production of permanent wealth, such as factories, buildings, railways and so on, not from the smartness of somebody who uses the Internet with minimal input of labor and capital.

Trying to assess the "prosperity effects" of the new high tech, the one question to examine is: What are its effects in terms of capital and income creation? Or, putting it again into Keynesian language: What are the multiplier effects of the high tech sector on the rest of the U.S. economy?

The short answer is, virtually zero. No measurable income or employment effects are spilling over, and the reason is easy to see: Producers of the high tech instruments easily meet the soaring demand for them by soaring productivity gains running at an annual rate between 40%–50%, requiring literally nil additional input of labor and material from outside the sector.

$350 BILLION VERSUS $24 BILLION

Behind the aggregate U.S. GDP numbers, there is a tale of two completely different economies: In the Old Economy industries, representing more than 95% of the whole economy, there is slow growth in investment, productivity, profits and pay. In the high tech New Economy, representing at best the other 5% of the U.S. economy, there is runaway productivity growth, fat salaries and even fatter options. If you average the two sectors, you get an economy that is doing extraordinarily well. But does that make sense?

Consider the following: According to the GDP calculations in chained dollars, U.S. businesses over the last three years up to end-June 1999 invested around $350 billion into computers. This accounted for no less than 40% of a $878 billion rise in real GDP during the same time. Isn't this the most fantastic investment boom of all times?

As we have explained several times, the computer figures in the U.S. GDP accounts, calculated in so-called chained dollars, are grossly misleading because, by focusing on the increase in computational power, they measure a technical effect, not the economic effects. It is a measure of spending that never took place. Relevant from an economic point of view are the effects in terms of current dollars. By that measure, though, business investment in computers rose not by $350 billion, but by a mere $24 billion to a total of $104 billion, and that over three years. For a $9-trillion economy, this increase and even the total amount are less than peanuts, and everybody knows the reason for this: the soaring productivity growth and collapsing prices in the computer-producing sector.

Putting it bluntly: For the time being, the new information technology is grossly overrated as an economic factor. There is an understandable, strong propensity to think that a technical marvel must essentially result in an economic marvel. But that's not true. Single firms may make a lot of money, either producing or using the new high tech or through capital gains by the owners in the stock market. In terms of capital formation and income creation in the economy as a whole, however, this technology still is and (as we suspect) may remain a minor factor.

WALL STREET BLAH-BLAH-BLAH

The other day, we read a comment in the *The Wall Street Journal* from Lawrence Kudlow, now chief economist at CNBC: *"Think of the Internet as an economic freedom metaphor for our time. The Internet empowers ordinary people and disempowers government. The Internet creates wealth, expands growth, produces jobs and spreads prosperity. Standing behind the Net is the political power of well over 100 million investors and asset owners.*

Because of this, I believe the future economy will outperform all expectations. The Dow Jones Industrial Average will reach 15,000, then 30,000, then 50,000 and higher. Believe it or not, the Internet is more important than the Fed."

This is not economics, this is blah-blah-blah. Yet this kind of nonsense has helped to fuel the Wall Street boom. In a recent, quite lengthy article in *Business Week*, another author raves about the "exponential gains in the speed of information processing insuring falling costs and enormous opportunities for growth in the New Economy industries." Yes, but how and to what extent does the new technology engender the growth and prosperity effects that elevate the economy as a whole? That is the cardinal question.

A common argument in extolling the benefits of the new high tech is that it helps businesses to cut costs. Again we have to point out that cutting costs, just by itself, does not create prosperity. If it succeeds, businesses raise their income at the expense of their employees, which happen to also be their main customers. The economy as a whole gains absolutely nothing.

As we have explained in connection with the prosperity effects of the Industrial Technology, there is but one chief source of rising prosperity, and that is capital investment. Involving labor and capital-intensive production processes, capital creation played the crucial role in propelling the prosperity of the Industrial Revolution. But for the reasons explained, all this is completely missing in the high tech boom of the 1990s. Industrial Technology was a growth engine; the Internet economy is not and will never be.

TECHNOLOGY-DRIVEN SLOWER GROWTH

The math on Amazon.com versus Barnes & Noble illustrates the key problem. Amazon is currently posting an annual sales rate of $1.2 billion, about equal to 235 Barnes & Noble stores. But because Amazon has spent only $56 million on fixed assets such as computers and warehouses, it has an enormous inherent cost edge over Barnes & Noble, which has spent $472 million on its 1,000 or so stores. Moreover, Amazon's investment in new warehouses can potentially support many times the present sales, implying very little need for further investments.

Amazon is spending into the red because it wants to grab customers from B&N. Somebody made a good quote on Amazon: "Their business is to sell dollars for 95 cents, and try to make up on volume...I love Amazon. A great service for the consumer but not a very good business. While B&N has heavily invested in brick and mortar for future profits, Amazon is heavily investing into losses for future profits. No wonder retailers in many branches worry about 'getting Amazonized.' Warns Cisco CEO John T. Chambers: 'Amazon versus Barnes & Nobles will happen in every industry."

It is clear the Internet will prove far more than just another new sales and distribution channel. It will do much more than intensify competitive pressure on firms. Essentially, it will undermine existing firms with high capital structures and high capital costs, squeezing their profits. But with such easy access to customers, the upstarts of yesterday will be threatened by the upstarts of tomorrow, at the expense of their profits. But, and that is the decisive point, this murderous competition is not conducive to higher investment spending. While the Industrial Revolution fostered technology-driven growth and prosperity across the economies through inherent massive capital investment, the Information Technology looks like fostering slow economic growth and profitless prosperity, owing to the low investment spending that it involves.

THE OTHER CULPRIT

But let's not loose sight of the starting point for our inquiry, namely, the presumption that the low inflation rates of the last years are structural and secular and will, therefore, stay with us in the long run. But, we asked, if the underlying causes are not monetary policy, what are they?

Actually, we see various causes, among them persistently moderate wage increases. However, the primary and dominating cause, in our view, is a fundamental break in economic conditions towards a distinctly slower growth trend than in the past. We see two main reasons for this change: The one is the New Information Technology, and the other one is a profound global shift in corporate culture. Their joint effect is a structural downtrend in the prime mover of economic growth: capital spending

The crucial point about Information high tech and Internet in this respect, as explained, is the implicated downward shift in investment spending. Always keep in mind, strong economic growth and rising prosperity are not children of capital usage but children of capital creation. By drastically reducing the requirements for capital input, the new technology is prone to promote a weak long-term trend in economic growth and in its wake a low inflation trend.

However, there is a second major influence working in the same direction of weak long-term economic growth, weak cyclical fluctuations, low inflation and low profits. That is a distinct break in business strategies concerning investment spending which started in the 1980s but has immensely intensified during the 1990s.

Around the globe, companies have become extremely reluctant in expanding capacity. Global corporate culture is focused as never before on raising profits through cost-cutting. Mergers and acquisitions, generally motivated by cost-cutting synergies, have become the preferred route of corporate expansion, rather than old-fashioned new investment. Similarly, the essence of restructuring, the other great feat of the New Era, really is corporate retrenchment. We are tempted to call this castrated capitalism.

Japan and East Asia were the latest exceptions from this developing mentality of corporate retrenchment. But their former forceful capital spending propensity has been cut short by the bursting asset and investment bubbles. In Japan's case, the capital spending ratio to GDP has plunged from 20% in 1991 to now about 13%, and it continues to decline. In Europe, this ratio is down to an unprecedented average low of about 16.5%, from well over 20% in the past. Not only that, these figures relate to gross investments before depreciation. Importantly, with the trend toward lower capital spending went a further sharp trend toward shorter-lived equipment, necessarily meaning an even sharper decline in net capital formation. As a result, net investment is today at record-low ratios to GDP worldwide. In quite a few countries, we suspect, it may be non-existent.

LOW INFLATION - STRUCTURAL AND SECULAR

In the course of the Industrial Revolution, capital spending tended time and again to exceed available savings. High and rising shares of fixed investment to GDP were consistent with high economic growth. But in times of loose money, it tended to engender inflation in consumer and producer prices.

Today, the relationship between investment and savings is the reverse. In most countries, savings now substantially exceed domestic investment which is definitely conducive to low inflation rates. While both aggregates have declined, the scale of investment spending has descended faster than savings. This is in sum and substance the structural cause behind the low inflation rates of today, and since we see long-term influences behind this development, we regard it as a secular trend.

The most extreme case in this respect is, of course, Japan. But precisely for that reason it is also a most instructive example. It has a tenacious personal savings ratio of 13% of disposable income, implying a corresponding gap in domestic demand. This savings-related gap used to be filled by high rates of investment spending and the chronic, large trade surplus. But business investment spending has dropped below current cash

flows, while the trade surplus is stagnating. Since 1993, corporate Japan is running a rising financial surplus that substantially adds to the financial surplus of private households. Essential result: overall contraction, deflation.

By the way, when we speak of deflation, we don't mean it in the conventional narrow sense of a decline in the price level of consumer and producer goods. The decisive determinant of prolonged, severe deflation and depression phases are pronounced and prolonged falls of capital values and capital investment. Together they spell overall contraction of the economy. Look at Japan in the past years and America in the 1930s.

The essence of deflation is not simply a decline in consumer prices but overall economic and financial contraction. But deflation, just like inflation, can develop in very different degrees. Its outcome depends on various factors, one of which is the magnitude of the imbalances that have accumulated during the boom. To stress the key point: Basic to inflation is an excess of investment spending over savings, basic to deflation is an excess of savings over investment spending.

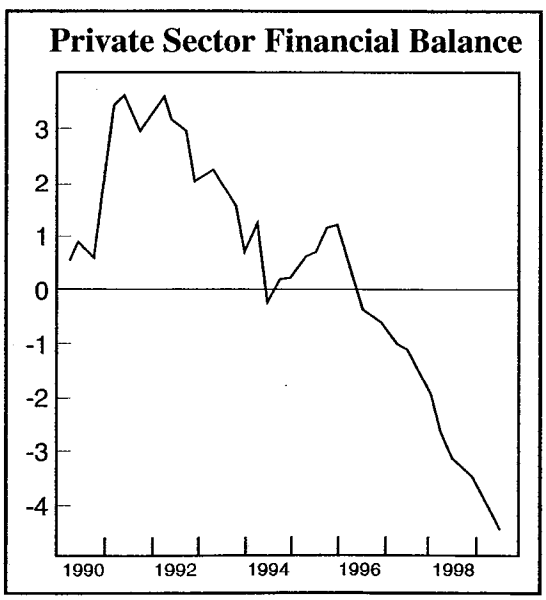
THE GREAT EXCEPTION: UNITED STATES

In our considerations and observations about inflation and deflation, we have not yet mentioned the case of the United States. There is a reason: It is the great exception in the world economy. While most countries are now running a savings surplus, America is "enjoying" the contrary extreme: a collapse of private savings. (U.S. investment figures are grossly distorted to the upside by the extraordinary measuring method for computers.)

Just to give an idea of the exorbitant contrast: In Japan, the private sector is currently running a huge financial surplus equivalent to about 16% of GDP. It says that overall spending by businesses and consumers is presently falling short of their current revenues by this staggering GDP ratio. In America, on the other hand, credit-driven business and consumer spending have gone literally through the roof. For the first time ever, the two are in the aggregate spending at a pace far in excess of current incomes, reflected in a joint net financial deficit of about 5% of GDP.

Trying to assess the U.S. economy's performance over the last years and its future outlook, we ought to begin with the investigation of what its prime mover has been. Putting it succinctly: Was it credit creation or capital creation? The figures on the next page, showing the changes in the relevant GDP components, give you the precise answer. They cover the last three years, ending with the second quarter of 1999.

According to the new era apostles, "U.S. economic growth in this expansion is centered in the high-tech sector." Superficially, this seems correct. Look at line 3 b, (table next page) relating to business investment in computers. This component accounted for almost 40% of 12.4% overall real GDP growth during this period -4.1% at annual rate. But taking out the computer sector, the other 99% of the economy has been growing at an annual rate of 2.5%.



But as we have repeatedly explained, this big rise in computer spending and manufacturing in the GDP statistics has taken place in spending that never happened. The quantum jump by $342 billion chained dollars is supposed to measure accumulated computational power. What matters for prosperity, however, is *income creation* in actual cents and dollars, and that has been a paltry $27.2 billion or 2.1% of GDP growth in current dollars over three years. In these terms, high tech is a manifest economic flop. But sheer investors' fantasy has turned the new high tech into the greatest paper wealth machine in history through its miraculous effects on the stock market. An imaginary world has been built up, as if the New Economy were representative of the whole economy.

COMPONENTS OF U.S. ECONOMIC GROWTH, IN BILLIONS OF DOLLARS

		1996II	1999II	Increase to GDP growth	% Contribution
1) GDP	chained	$6,943.8	7,803.6	859.8	
GDP	current	$7,607.7	8,893.3	1,285.6	
2) Private Consumption	chained	$4,712.2	5,384.7	672.5	78.2%
	current	$5,189.1	6,148.3	959.2	74.6%
3) Fixed investment	chained	$1,035.7	1,373.6	337.9	39.3%
	current	$1,082.0	1.407.1	325.1	
a) Structures	chained	$185,6	207,2	21.6	2.5%
	current	$210.6	255.7	45.1	
b) Computers	chained	$152.0	494.0	342.0	39.8%
	current	$76.8	104.0	27.2	2.1%
c) Industrial	chained	$118.8	131.9	13.1	1.5%
	current	$129.2	156.6	27.4	2.1%
d) Residential	chained	$277.2	340.1	62.9	7.3%
	current	$312.7	413.1	100.4	7.8%
4) Net Exports	chained	$138.9	323.0	184.1	21.4%
	current	$93.8	225.7	131.9	10.2%
5) Increase of debts:					
a) Private Households		4,940.6	6,170.0	1,229.4	
b) Businesses		4,404.8	5,707.8	1,303.0	
c) Financial Sector		4,528.0	7,073.6	2,545.6	
TOTAL CREDIT EXPANSION		5,078.0			

Source: Survey of Current Business, Department of Commerce

Two other aggregates, instead, make it crystal clear what the true, overriding propellant of U.S. economic growth in recent years has been: a runaway credit expansion on the one hand, consumer spending on the other, accounting in these years for almost 80% of GDP growth. This compares with a long-term consumption ratio of 63% of GDP. To talk in the face of this consumer borrowing and spending binge of a high tech-driven new era in economic growth is really ludicrous.

We hasten to add that economic growth is essentially always credit-driven. What makes the decisive difference are always two things: quantity and quality of extended credits; that is, the purposes which they serve. Principally, there are three different possible outlets: investment, consumption and speculation in certain asset classes. The present U.S. credit boom is unique in history both in respect to quantity and quality.

The extraordinary excess in quantity is best gauged by comparing credit growth with nominal GDP growth as a broad measure of current economic activity. It reveals credit excesses of unprecedented magnitude, inherently implying that the borrowed money went overwhelmingly into uses outside of the GDP—essentially into corporate leveraging, highly leveraged speculation in the financial markets and, to a smaller extent, into import financing. As to the credit flows that were directed into GDP, the credit statistics show one overwhelming purpose: consumer spending. Overall, this implies a credit expansion of a most miserable quality. Bringing another important aspect to attention: It's virtually all unproductive credit.

FINANCIAL BUBBLES PRECIPITATE DEFLATION

But isn't the U.S. economy overheating with accelerating inflation rates? Doesn't that disprove our proposition of a secular trend of low inflation? Not at all. In the first place, we have to recall the fact that the U.S. economy, with its booming domestic demand, is the great exception in a world where excess capacity and low demand growth generally prevail. Second, what we have been stressing as the influences that warrant low

inflation in the long run are structural changes restraining economic growth and inflation on a global scale, while the U.S. economy's present overheating is clearly of purely cyclical nature, fueled by excess credit.

For good reasons, America has the highest inflation rates among the industrial countries, and if it were not for the massive diversion of excess demand into the soaring import surplus, the inflation rates would be a lot higher. What's more, most of the inflation is in the asset prices in the financial markets. In the U.S. economy, inflation is indeed rampant, although the conventional price indexes show very little of it.

We are left with the question of whether the present U.S.-led global economic recovery could possibly spill over into sustained *global* consumer price inflation. Our answer is: not under any circumstances. While the rest of the world is recovering, it is not conditioned to embark on a new boom. On the other hand, the U.S. economy is a highly vulnerable bubble economy that has largely spent its force.

There is a widespread belief that a bursting asset bubble involves a massive outflow of money into other markets or parts of the economy. No, the money inside the financial bubble is essentially locked in and exposed to destruction because it can exit only as long as others are ready to buy the bubble assets which they will do only at sagging prices. Importantly, therefore, it lies in the nature of runaway inflation in financial assets that they preclude following inflation in the economy. The money in the bubble is irrevocably trapped. The regular and inevitable aftermath of asset inflation, therefore, is hard deflation in the markets and the economy.

However, if the dollar enters a prolonged, sharp fall, resulting higher U.S. inflation rates and interest rates are sure to deflate values both in U.S. equities and bonds, precipitating and worsening the bubble's burst. On a global scale, on the other hand, the already virulent deflationary forces will be drastically reinforced.

CONCLUSIONS:

The greatest equity bull market in history is definitely in the stage of mortal agony. While the stock indexes are still looking rather good, the majority of stocks are down 20%, 30% or more from their highs. But more and more big stocks are being knocked off.

The last stronghold of the bulls is a narrow list of high-tech stocks, Internet stocks in particular. Excluding that sector, the S&P 500 has barely increased over the last two years.

A decisive breakdown in high-tech shares would certainly precipitate the great crash.

There is no crash yet, but relentless erosion of liquidity, as best gauged by the dreadful action of the plunging advance-decline ratio. No trigger is needed. Without momentum, the great bear market is inevitable.

Given the huge U.S. trade deficit, the risk of a falling dollar also has to be taken into account. A pronounced and extended dollar bear market could well pull down not only U.S. stocks and bonds, but the world economy. We regard this as the overriding risk for 2000 and beyond.

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